The limits of insurance regulation will not vanish if and when Uncle Sam becomes a regulator. Federal oversight will not tame the underwriting cycle—only insurance executives can work toward its stabilization.

# Federal Oversight: The Wrong Answer

BY MARTIN M. SIMONS

The foundations of state regulation of insurance are once again being chipped away by individuals who feel that some form of federal oversight will bring magical improvements to the insurance-buying process. After taking all factors into consideration, however, one realizes that there is no concrete evidence that federal intervention will result in perfect, or even substantially improved, regulation. Moreover, the crux of the matter lies not in who does the regulating but rather in the basic concepts of regulation, the ratemaking process and the subsequent actions of insurers.

The principal activities of insurance regulators revolve around insurer solvency and rate adequacy. Regulators monitor solvency through yearly analyses of insurance company annual statements and through more frequent analyses when potential problems are perceived or expected. Ensuring the adequacy of rates, on the other hand, can involve a variety of procedures, depending on the rating laws of the state concerned.

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Our primary focus here will be on the rate-filing process, although the concepts discussed also apply to other forms of analysis performed by regulators and to the functions performed retrospectively in file-and-use or use-and-file jurisdictions (in which the analysis of individual rate filings may be performed after the underlying rates have been placed in effect).

In filing for a rate revision for a given line of insurance in a given state, an insurer provides the regulator with an estimate of future expectations based primarily on its past experience. However, when there is not enough underlying statistical data on which to base the forecast, actuaries use credibility formulas developed to statistically forecast the future based on underlying past experience.

Projections then are made for premiums, losses, expenses and expected investment income. Premiums are adjusted to the filer's current rate level, and losses are projected using a least-squares method or some other statistical process. Expenses are generally treated as a budgetary item or included as an average of the insurer's past experience from a number of recent years.

Investment income projection techniques run the gamut from total return analysis to total exclusion (a tactic that is utilized in the hopes that the regulator won't notice). Most companies and rating bureaus use filing methodologies that have been developed and refined through many years of actuarial experience. And most insurance companies are extremely consistent in the methodologies and in the underlying statistical techniques that they use. Actuarial professionals also command great respect for their ability to understand and use those techniques.

## OUT OF CONTROL

Despite this process, however, the property/casualty industry has been plagued with an underwriting cycle that affects all lines and diminishes both the regulator's and the consumer's view of the insurance ratemaking process. As if the existence of a cycle were not confusing enough, its phases appear to become more extreme as time goes by. It appears that the more we know about the underwriting

cycle, the less we are able to control it. How—given the highly sophisticated state of today's actuarial science—can this paradox exist?

The answer lies in understanding the projection techniques used by industry ratemakers. Premium projection methods generally ignore the basic economic principle of supply and demand and often fail to account adequately for actions that have a direct impact on future premium income and operating results. For example, loss projections are greatly influenced by changes in claims-handling practices, but these are rarely taken into account in initial rate filings.

Furthermore, reserve fluctuations can cause extreme differences between projected losses and those actually incurred. In forecasting expenses, companies also rarely account for those of their strategies that will have a definite upward or downward impact on the future level of commissions, salaries and other controllable company expenses until they receive the rate regulator's input.

Projection techniques also are limited in that they cannot produce a single-point estimate—that is, a single definitive expected value for future premiums, losses, expenses or investment income. While loss trends are typically determined using a linear or exponential statistical technique, future events often bear little or no relationship to the forecaster's underlying assumptions. In fact, rate increases or decreases are affected by economic laws that bring about unquantifiable changes in the insurer's customer base, and assumptions regarding future levels of expense or investment income will vary depending on both the statistical methods employed and the individuals making the assumptions.

The limitations of forecasting produce a range of expectations, and at their best, current techniques can only point out the minimum and maximum values of that range for each of the forecast criteria. These limitations are not the fault of the individual forecaster, but of the underlying variables and complexities of the property/casualty industry—many of which cannot be specifically defined. In actuality, the future rarely acts in concert with our expectations, regardless of the level of our expertise.

These variables tend to widen the range of expected future behavior and thus to lessen the confidence we may have in the projections involved. When individuals estimate, they naturally bring biases into the process. In some cases the bias includes limitations in knowledge; in others, mere wishful thinking may be at work. This applies equally to the filing company, the regulator and any entity that may intervene in the rate approval process and perform its independent analysis.

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It is at this juncture, then, that the regulator and the filing company or bureau generally find themselves at odds with one another, since each forecaster is faced with determining the appropriate point in the range of probable future expected values in order to meed his or her specific objectives.

The regulator's goals include maintaining solvency and ensuring that rates meet the normal statutory requirements by not being excessive, inadequate or unfairly discriminatory. In addition, the regulator must work to foster a healthy marketplace that provides insurance availability with as few disruptive forces as possible. Meanwhile, the insurance company that is filing for a rate change is concerned with profits and premiums or growth in business in force.

Quite naturally, both the insurer and the regulator will bring biases to the process and will develop analytical techniques designed to meet their specific goals. Since such goals are somewhat disparate, both parties will typically arrive at a different point in the range of possible future outcomes for each of the forecast criteria.

Again, this process varies according to the jurisdiction involved. In some states the regulator and the filer meet and exchange ideas in a conference room, and this approach fosters a "give and take" attitude regarding the underlying criteria and assumptions used to arrive at projected results.

In other states, the process is more formal, and the exchange of ideas is made publicly in a hearing room, allowing a legislatively appointed hearing officer or board to decide among the various views presented. In still other jurisdictions, rates are actually established by a rating board that has the statutory authority to do so. In each case, the desired result is a rate level that is neither excessive, inadequate nor unfairly discriminatory—a legal requirement for all property/casualty lines of insurance in virtually all 50 states.

Frequently (and appropriately), a compromise is reached between the filer and the regulator, which includes the goals—and hence the biases—of each party. Generally, the result is a rate lower than that requested by the filer and higher than that originally contemplated by the regulator. This system allows for input by virtually all parties who will be affected by the results of the rate approval process.

## SHIFTING GOALS

Despite this seemingly utopian chain of events in which each entity involved plays a part in the ratemaking process, the underwriting cycle remains untamed. In their efforts to meet their growth and profit goals, insurance company executives use techniques that are not generally considered during the rate-filing process. For example, schedule rating credits are revised—even though there has been no underlying change in the risk being insured. Often insurance companies are either centralizing or decentralizing, causing drastic and unaccounted-for changes in the underlying cost of doing business. The industry shifts between its two goals of growth and profit, reacting to a cycle that is caused by its own reactions and giving little consideration to revising the underlying filing criteria that are directly affected by their actions.

Federal oversight of the insurance industry will not drastically alter this chain of events. No state was left unscathed by the most recent under-

writing cycle; states with strong prior approval laws were faced with availability problems, as were states with an "open competition" atmosphere. This scenario was followed by some huge rate increases in many lines of insurance in virtually all jurisdictions.

To believe that the federal government in its infinite wisdom could have avoided this situation is ludicrous. One need only point to the saga of federal regulation in the airline industry as proof that federal involvement is not the panacea that its proponents would have us believe. The limits of regulation will not vanish if and when Uncle Sam becomes a regulator. Federal regulation will not tame the underwriting cycle, nor will state regulators and consumers. Only insurance industry executives can bring stability to property/casualty results.

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Every action taken in pursuit of growth and profit has an effect on resulting experience, and the underwriting cycle extremes can be tempered only when those effects are included in the ratemaking process. This inclusion is most difficult to achieve during those times when the growth goal overshadows the profit goal, but it is necessary during all phases of the cycle. Still, there are examples in the industry which prove that stability can be attained and maintained—and that stability does produce substantial long-range growth and profit for the company practicing it.

## OUR RESPONSIBILITY

Since we are currently entering one of those cycle phases when we hear that the market is softening, the need for consistency in the tactics and strategies of insurance industry executives is paramount. The wounds inflicted by the last underwriting cycle have not yet begun to heal, so it is incumbent upon both regulators and insurance executives to maintain consistency at all costs.

If rates are cut to a point below profitability now, they will only be followed by another round of intolerably huge rate increases later on. This scenario will further damage the industry's image and will cause additional reactions on the part of the federal government. We must all be aware of our actions as we enter this next phase and must remember that the current regulatory system, while not perfect, is viable and has provided the industry with the ability to grow and improve during the last four decades. □